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Economic Outlook

The Dangerous Preference for Fixed Exchange Rates

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The current preoccupation of the G-7 nations (excluding the United States) with pegging exchange rates among major currencies follows downright perversely on the heels of nearly two years of disastrous efforts to foist exchange rate rigidity onto developing countries. Fortunately, the refusal by America alone to join the drive toward repegging currencies is sufficient to stop it. One would think that the Japanese—who, intermittently, have made heavy use of exchange rate depreciation to cushion the rising deflationary momentum on their unfortunate island—would be in favor of continued flexibility of exchange rates. But, disoriented and weakened by continued adherence to the old symbols of stability, hard money, and a stable currency, the Japanese can be counted on to side with the Europeans in pushing for exchange rate pegs, as they did at the recent G-7 meeting in Bonn.

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Today, twenty years after the great battle against global inflation, most central banks and the International Monetary Fund have replaced the productive goal of avoiding inflation during an era of excess demand with the counterproductive goal of preventing currency devaluations during an era of excess supply. The prevalence of excess capacity (supply) has meant that the battle against currency devaluations has been lost in the developing countries of the world, with the list of losers extended from Thailand, Indonesia, and South Korea in 1997 to Russia in 1998 and Brazil in 1999.

With their devaluations, the developing countries have exported very harmful deflation to Japan where it is already present, moderately harmful deflation to Europe where it is about to appear, and helpful deflation to the United States where it has served as a powerful tonic to extend dramatically an investment-led expansion. What happens over the next year in this excess-supply environment, which is so baffling to most policymakers, is crucial to avoiding a global financial meltdown. While central banks know how to end inflationary episodes by raising interest rates and slowing money growth, many are puzzled about how to end deflationary episodes. Witness

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the current struggle over deflation at the Bank of Japan, the rising tension with fiscal policy at the European Central Bank, and the queasiness attending a soaring U.S. stock market and economy at the Federal Reserve.

Lies upon Lies

As the twentieth century draws to a close, it seems that lying about exchange rate pledges has replaced lying about price stability as the fashion among central banks outside of America. The failure during the 1970s by G-7 central banks, especially the U.S. Federal Reserve, to keep their promises about price stability created an excess-demand hot potato scenario. Rising prices in industrial countries caused booms in emerging markets, especially Latin America, which pulled investment capital into those areas. The booms ended when the overheating got intolerable in the industrial countries (especially the United States) and the Federal Reserve called an end to the easy money scenario. Fed tightening, begun in 1979–1980, eventually collapsed the emerging market boom in 1982 when Mexico declared itself unable to service its debts. There followed a major Latin American debt crisis associated with the battle to control inflation that, in turn, was necessitated by a failure of the Federal Reserve and other major central banks to keep their promises of stable prices.

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Reacting to the clear costs of the inflationary environment during the late 1970s and early 1980s, the United States, Europe, and Japan persistently reaffirmed their commitment to price stability, and this spread abroad to the emerging markets. The late 1990s has seen the hot potato of excess supply replace the hot potato of excess demand in the 1980s. Under the excess supply scenario, emerging markets pegged their currencies to the dollar, which was stabilized by the Fed's long and persistent anti-inflation efforts. Such pegging of the currencies of emerging markets allowed investors in these markets to use dollar interest rates, held unusually low by the Fed's anti-inflation efforts, to finance a myriad of investment projects. The unusually low cost of capital in the emerging markets created a chronic excess supply (capacity) situation; consequently the hard currency pegs to the dollar were no longer viable. One by one, the currencies of emerging market countries such as Thailand, Indonesia, South Korea, Russia, and Brazil have been devalued in an effort to redress the problems of large excess capacity.

The export of the excess supply conditions in the emerging markets has created a triple benefit for the financial markets and the economies of the developed world, especially the United States.

The following description of Shanghai, another classic case of excess capacity problems, is typical:

> Shanghai's property sector is the most obvious case of excess capacity. Over two thousand high rises have been completed in the city in the 1990s. There are around five hundred under construction. Optimistic estimates project that it will take ten years or more to fill the existing buildings. If the property sector is cut back, Shanghai's economy will clearly slow down. The whole country has a similar problem. The manufacturing sector and the property sector account for about two thirds of the total investment. If these two sectors have to invest less, can investment drive the economy?
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> If investment and consumption won't lead the economy, it leaves only the external sector. East Asia is still crawling at the bottom. Europe is slower than last year. The U.S. probably peaked in Q4 1998. China will have to go for market share to achieve higher export growth, which means trouble for other East Asian economies.

This description of Shanghai's and China's economic problems and the need to export deflation was written in one of Morgan Stanley's daily reports by Andy Xie, a Morgan Stanley analyst based in Hong Kong. It is typical of the Asian economy's problems. Whereas in the 1970s excess demand conditions in the developed G-7 economies ultimately benefited the commodity-sensitive emerging markets, the process has been reversed in the 1990s. The promise by the central banks of the emerging markets to maintain a peg to the dollar put the cost of capital too low and created an excess supply situation among emerging markets that has so far greatly benefitted the developed economies of the G-7. The export of the excess supply conditions in the emerging markets has created a triple benefit for the financial markets and the economies of the developed world, especially the United States. The collapse of the economies of the emerging markets has lowered the prices of raw materials while simultaneously creating a reflux of capital back to the safe haven of developed economies. The acute phase of the crisis in the emerging markets, the devaluation and default by Russia in August 1998, and the near failure of Long-Term Capital Management created enough turbulence in the financial sector of the advanced countries to cause the Federal Reserve to ease sharply—cutting interest rates by 75 basis points in six weeks—and to accelerate money growth through the end of 1998.

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Except in the United States, the global need is demand growth. As a result, monetary policy in the United States, accommodative as it has been, is oddly far more appropriate for areas such as Europe and Japan, where demand growth is inadequate, prices are falling, and unemployment is rising. Japan and Europe must now export deflation, with the United States as importer. But some problems in financial markets may arise in this process.

Good News–Bad News

Two events sound like good news but actually jeopardize the stability of financial markets in the United States, Europe, and Japan. First, the acute phase of the debt crisis in the emerging markets is probably over. The end of that phase was marked by the Brazilian devaluation, which, while disrupting markets in Latin America, was not the calamitous, systemic risk-threatening event expected. The need to hold the line in Brazil was used instead to justify a $40 billion gift package for the Brazilian government from the IMF. That package will be delivered no matter what the Brazilians do. Having cut their currency loose, the Brazilians will begin the business of rescheduling their debts and will allow private-sector demand to rise to deal with excess capacity in Brazil, while the government attends to shrinking its bloated public sector.

With Brazil's devaluation in mind, compare the performance of two different Latin American economies, Mexico and Argentina. Mexico has elected to absorb the strain of Brazil's devaluation by letting its own currency devalue, while Argentina is maintaining a rigid peg to the dollar. During the month after the Brazilian devaluation on January 13, the stock market of Argentina fell by 2.1 percent while Mexico's stock market rose by 25 percent. Clearly the relief of problems in excess supply is the appropriate policy in a world of considerable excess capacity.

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The second major event was Japan's decision on February 15 to reverse its hard yen policy. After touting the benefits of a strong yen for months, Vice Minister of Finance Eisuke Sakakibara released a statement through his pipeline to the hedge-fund community, Medley Global Advisors: "I am now willing to tolerate a weaker yen, because it will be driven by the Bank of Japan's correct decision to liquefy the Japanese money supply. As the yen declines in response to this new policy shift, you can be assured that I will not stand in the way. We will not oppose it."

Sakakibara's statement followed another failed effort at reflation by Japan's central bank. The Friday before this statement, the Bank of Japan cut the overnight rate from twenty-five basis points to fifteen basis points or lower. The aim was to signal an easing of monetary policy. After a brief sell-off of yen and a rally in Japanese government bonds, the movements were reversed, with the yen strengthening again and JGBs selling off. Because more action was required to create the desperately needed reflation, Sakakibara leaked his comment about a weaker yen. Meanwhile, the Ministry of Finance announced that it would buy an extra $3.5 billion

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in Japanese government bonds by March 31 (the end of Japan's fiscal year) to avoid having a weaker currency push up interest rates in Japan and to minimize balance-sheet damage to Japan's financial institutions from much lower prices of government bonds.

Watching Japan carry out its efforts at reflation is somewhat akin to watching an inept driver attempt to shift the gears on a fine automobile. The frequent gnashing of gears is painful. Japan knows that it must reflate and late last year announced its seventh package of fiscal stimulus to push up demand. Financing the package, however, led to such an increase in the supply of Japanese government bonds that interest rates rose sharply from well below 1 percent to more than 2 percent in a month. Now Japan hopes to push down its currency and thereby join the reflation league without allowing its interest rates to rise.

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Engineering this will be difficult, since a falling currency pushes up interest rates in two ways. First, it raises expected inflation, and, second, it increases expected growth by shifting demand onto Japanese producers and away from producers elsewhere. Indeed, a rise in interest rates in Japan from current levels to 3.5–4 percent would be a desirable symptom of a recovering Japanese economy. Since Japanese banks hold large stocks of JGBs on their balance sheets, the government will try to eat its cake and have it too by depreciating the currency and getting the economy to recover while trying to avoid higher interest rates. This is impossible. If Japan gets the economic recovery desperately needed by reflation, the yen will fall, and interest rates will rise—probably to 3.5 or 4 percent—especially in view of the $300–500 billion supply of new bonds that the Japanese government must sell each year to finance its spending programs and bank bailouts.

If the acute phase of the debt crisis in the emerging markets has stabilized with the Brazilian devaluation and the Japanese have rejoined the reflation camp, the rally in the financial markets in the United States and, by association, in Europe is in jeopardy. As so often the case when policymakers obtain their most fervent wishes, the byproduct in financial markets is less than desirable. G-7 policymakers have been hoping for a stabilization of the debt crisis in the emerging markets and a recovery in Japan since June 1997, when the overt deflationary crisis first hit. The byproducts of that crisis—falling commodity prices, the capital flow to financial markets in developed countries, and extra Fed easings—have been remarkably constructive for the equity markets in the United States and Europe. Now that the process is ending, clear sailing in U.S. equity markets, not to mention U.S. bond markets, may be over.

A New Race?

Market conditions will undoubtedly return to those prevailing just before the acute phase of this debt crisis in August with the Russian devaluation and default. At that time yields on U.S. ten-year bonds were about 5.5 percent, compared with about 5 percent in mid-February 1999. True, the federal funds rate at 4.75 percent today is more supportive of lower U.S. yields than last summer at 5.5 percent, but Japanese bond yields at 2–2.5 percent, instead of the 0.9 percent levels of last summer, are less supportive of lower U.S. yields. The Standard & Poor's stock index stood just below 1,100 last August, about 15 percent below 1,250, the high reached in mid-February. The dollar was at 145 yen per dollar before a two-stage collapse that took it as low as 110 yen early this year.

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The lower commodity prices that improved American terms of trade, the search for a safe haven in rising U.S. financial markets, and the easier U.S. monetary policy in the fourth quarter of 1998—all part of the acute phase of the global financial crisis—added mightily to U.S. economic performance. During the fourth quarter of 1998, stronger investment spending along with continued consumption growth and intensified government spending resulted in a 5.6 percent growth rate with low (0.8 percent) inflation. But now Brazil's devaluation and the relatively calm aftermath have signaled an end to the bogeyman of systemic risk that was haunting policymakers as they watched the debt crisis in the emerging markets; Japan seems to be coming to its senses about the need to reflate. And the easiest of times for the U.S. economy are behind it. In 1997 and 1998 the U.S. economy, with the wind at its back, was the fastest racecar on the track when all the slow cars break down and move to the sidelines. The winner posted great lap times in the form of high growth rates in the gross domestic product and higher valuations of the earnings of U.S. companies.

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When the slower cars have been repaired and get back onto the track, the U.S. economy, though the fastest in the world, must navigate through some traffic such as a possible firming in raw materials prices, stable-to-rising interest rates, and a neutral Fed that might even consider tightening if any signs of wage pressure emerge. Lap times for the fast car, represented by price-to-earnings ratios in the stock market, begin to drop back to normal. A price-to-earnings ratio for the S&P stocks of 25 on $40 per share would take the S&P down by about 25 percent, to 1,000 from its current lofty level of 1,250 with a price-to-earnings ratio of 30. These adjustments are not a disaster for the United States but rather a return to normalcy for the costs of raw materials and costs of capital. The parallel development will be a return to normalcy in the pricing of the earnings streams expected from U.S. firms as the resumption of global demand growth reduces the excess supply problem and all the positives that it has brought to the U.S. economy.

While the stock market may return to more normal levels relative to prospective earnings, bond yields may revert to levels prevailing before the Russian and LTCM crises, about fifty basis points above current levels. Mitigating the rise in bond yields will be a likely strong appreciation by the U.S. dollar, especially against the yen, as Japan reverts to currency depreciation to reflate external demand in its efficient traded-goods sector. Japanese interest rates will also have to rise, a process inevitable in an economy that is starting to recover. Even at zero inflation, Japanese interest rates would average around 3.5 percent without the huge prospective supply (the equivalent of more than $350 billion a year in new Japanese government bonds) currently facing global financial markets. Japan must remember that if it gets its wish and the economy starts to recover, one byproduct will be higher interest rates, which in turn will be signaling higher real returns available in the Japanese economy and a reversal of the deflationary forces that have taken hold over the past year.

If the world has learned anything in the past two years, it ought to be that promising stable currencies in a deflationary world characterized by excess capacity is a cruel hoax. Fighting for exchange rate stability in a world of excess capacity is not the moral or practical equivalent of fighting inflation in a world of excess demand, as the IMF, the European Central Bank, and the Bank of Japan seem to have supposed.

The Federal Reserve will probably welcome the strength of the dollar. The sharp easing last fall, accompanied by an acceleration of economic growth close to 6 percent, or twice the Fed's sustainable rate, has created some restiveness about the degree of accommodation of U.S. monetary policy. A stronger dollar shifts demand away from U.S. producers and will help to relieve any incipient overheating pressure that might have built up in the U.S. economy. The underlying strength of that economy is still a useful lever that global policymakers can employ to pry the world out of its current deflationary slump of excess supply, but currencies (including the yen and the Euro) must be permitted to weaken to shift demand growth away from the United States and onto Japan and Europe.

It would be heartening to hear from the G-7 some recognition of the distinction between the desirability of seeking price-level stability in a world of excess demand and the dangers of pursuing exchange rate rigidity in a world of excess supply.

The problems in the emerging markets and in Japan are by no means over. But events of the past month indicate that they have probably passed their most acute phase. The next problem facing world financial markets and policymakers will be to make room for some of the slower economies to get back into the race. This allowance will require the U.S. economy to throttle back; a stronger dollar is probably the ideal way to accomplish this move. A stronger dollar as the mirror image of weaker currencies elsewhere—which may be interpreted as the abandonment of promises to maintain fixed exchange rates—is not a bad thing.

If the world has learned anything in the past two years, it ought to be that promising stable currencies in a deflationary world characterized by excess capacity is a cruel hoax. Fighting for exchange rate stability in a world of excess capacity is not the moral or practical equivalent of fighting inflation in a world of excess demand, as the IMF, the European Central Bank, and the Bank of Japan seem to have supposed. Efforts to further the cause of a fixed exchange rate in a world of excess capacity are a mistaken carryover from the last global debt crisis in the 1980s, when promising price-level stability and hard currencies was the way out of the crisis.

It would be heartening to hear from the G-7 some recognition of the distinction between the desirability of seeking price-level stability in a world of excess demand and the dangers of pursuing exchange rate rigidity in a world of excess supply. Failing that, we shall have to rely on the markets and the Federal Reserve to do the job for them.

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